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**DISTINGUISHING TAX EVASION FROM  
AGGRESSIVE BUT LAWFUL TAX REPORTING**

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## **DISTINGUISHING TAX EVASION FROM AGGRESSIVE BUT LAWFUL TAX REPORTING**

*“There is no kind of dishonesty into which otherwise good people more easily and frequently fall than that of defrauding the government.” – Benjamin Franklin*

*“[The tax evader is] in every respect, an excellent citizen, had not the laws of this country made a crime which nature never meant to be so.” – Adam Smith*

### Introduction

Understanding the difference between the crime of tax evasion and conduct which is merely aggressive, but lawful, involves a broad understanding of the “system of sanctions” designed by Congress “to induce prompt and forthright fulfillment of every duty under the income tax and to provide a penalty suitable for every degree of delinquency.” *Spies v. United States*, 317 U.S. 492, 497 (1943). The system of sanctions includes both civil and criminal penalties. One must also understand the so-called anti-abuse doctrines, such as the economic substance doctrine, which are of growing importance in the government’s war on aggressive tax positions.

This article will attempt to provide a succinct overview of the system of sanctions and the anti-abuse doctrines and will show how these concepts are now applied in criminal tax enforcement. One should keep in mind the Supreme Court’s admonishment when considering these doctrines: “It is not purpose of the law to penalize frank differences of opinion or innocent errors made despite the exercise of reasonable care. Such errors are corrected by the assessment of the deficiency of tax and the collection with interest for the delay.” *Id.* at 496.

## Tax Evasion Defined

The capstone of the system of sanctions is the crime of Tax Evasion. That offense is defined at Section 7201 of the Internal Revenue Code as follows:

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than five years, or both, together with the costs of prosecution.

Willfulness is defined as “the intentional violation of a known legal duty.” *United States v. Pomponio*, 429 U.S. 10, 12 (1976). Subscribing a False Return and Willful Failure to File a Return are also used for basic criminal enforcement. Section 7206 of the Internal Revenue Code makes it a felony for a person to “willfully” prepare or subscribe under penalties of perjury a tax return, statement or other document, which is not true and correct as to every material matter. Section 7203, a misdemeanor statute, makes it a crime to “willfully” fail to file a return, pay a tax or supply information at the time or times required by law or regulation.

The crime of tax evasion may be committed in two broad ways. First, by evading the correct assessment of the tax (usually by the filing of a false income tax return), and second, by evading a payment of an already assessed tax. The latter offense, evasion of payment, ordinarily involves some act to conceal a bank account or assets from the IRS after assessment. See, e.g., *United States v. McGill*, 964 F.2d 222 (3d Cir. 1992). The essential elements of Tax Evasion is a “willful attempt.”

In *United States v. Spies*, the Supreme Court stated that the distinction between the felony and misdemeanor offenses is based on the term “attempt.” The Court

described, in broad terms, what “attempt” means in the context of the more serious felony violation:

By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one’s affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or conceal.

The Internal Revenue Manual provides a detailed list of fraud indicators. The Manual states that fraud indicators serve as a sign that actions may have been done for the purposes of deceit or concealment. U.S. Department of the Treasury, *Internal Revenue Manual*, 25.1.2.3, available at [http://www.irs.gov/irm/part25/irm\\_25-001-002.html](http://www.irs.gov/irm/part25/irm_25-001-002.html) (last visited Mar. 17, 2010).

#### Civil Penalties And Disclosure Requirements Must Also Be Considered

Section 6662 of the Internal Revenue Code, the “Accuracy Penalty,” provides broad normative standards for correct tax reporting. It provides a penalty for “negligence” or “disregard” of rules or regulations. Negligence is “any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.” I.R.C. § 6662(c). A “reasonable basis” is the minimum requirement for lawful tax reporting. a reasonable basis is “a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper.” Reg. § 1.6662-3(b) (2003). “The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.” *Id.* The Accuracy Penalty also requires disclosure of a tax position which may result in a substantial understatement of tax. A substantial understatement

of tax is the greater of 10% of the tax required to be shown on the return for the taxable year or \$5,000. Disclosure is required to avoid a penalty if the tax position is not supported by “substantial authority.” This substantial authority standard is an objective test which is less stringent than the “more likely than not” standard and more stringent than the “reasonable basis” standard. There is substantial authority for the tax treatment of an item only if the weight of authority supporting such treatment is substantial with respect to the weight of authority supporting contrary treatment. Thus, a taxpayer’s position must be stronger than one that is arguable but fairly unlikely to prevail in court. Reg. § 1.6662-3(b)(3),(4). Disclosure will not be considered with respect to a tax shelter item. In general, a tax shelter is a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(C).

Section 6664(d) of the Internal Revenue Code provides an exception to the Accuracy Penalty. It provides that no penalty shall be imposed if it is shown that there was “reasonable cause for the understatement and the taxpayer acted in good faith.”

#### Tax Preparer Penalty

Section 6694 of the Internal Revenue Code provides a penalty which applies to tax preparers and certain advisors with respect to “unreasonable tax return positions.” The penalty has three separate tiers. Disclosed positions must be supported by a “reasonable basis.” Undisclosed positions must be supported by “substantial authority.” Tax shelter and reportable transactions are subject to a penalty “unless it is reasonable

to believe that the position would more likely than not be sustained on its merit.” I.R.C. § 6694(a)(2).

The due diligence standard applies. A tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer, another preparer or advisor. However, the tax preparer may not “ignore the implications of information furnished or actually known by the tax return preparer.” Tax preparers must also make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. Additionally, where the Internal Revenue Code requires that specific facts and circumstances exist, for example documentation requirements, the tax preparer must make appropriate inquiries to determine the existence of the facts and circumstances required by a Code section or regulation as a condition for the claiming of a deduction or credit.

### Tax Shelters

The advent of the so-called “technical” tax shelter in the 1990’s produced major responses from the Government. First, the Government began to successfully challenge structured transactions by relying on common law anti-abuse doctrines, such as the economic substance doctrine. This doctrine is said to be a composite of the “business purpose” doctrine and the “substance over form” doctrine and the “sham transaction” doctrine. *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (Fed. Cl. 2004), *vacated by* 454 F.3d 1340 (Fed. Cir. 2006). The doctrine evolved from *Helvering v. Gregory*, 69 F.2d 809 (2nd Cir. 1934), *aff’d* 293 U.S. 465 (1935) (L. Hand, J.). There, the taxpayer owned a corporation which owned valuable shares in another corporation. To avoid the corporate tax on a gain from the sale and the resulting dividends, a “plan

was conceived” whereby a new corporation was formed and the shares transferred in a tax free reorganization. Three days later, the new corporation was liquidated and the stock distributed in a liquidating distribution, whereupon the stock was sold. Judge Learned Hand rendered the opinion of the Appellate Court:

All these steps were real, and their only defect was that they were not what the statute means by a ‘reorganization,’ because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect.

*Id.* at 810. Judge Learned Hand analogized: “[T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes.” *Id.* at 810-11. Affirming, the Supreme Court stated: “[T]he question for determination is whether what was done, apart from the tax motive, was the thing the statute intended.” *Gregory v. Helvering*, 393 U.S. 465, 469 (1935). Since then, the doctrine has been stated in various forms, but is based upon the principle that economic substance not mere formal compliance with the Code must inform the interpretation and application of the tax law.

#### “Real Deal” Tax Benefits May Be Transferred Between Parties

Under the economic substance doctrine, “real” tax benefits may be transferred between parties. In *Frank Lyon Company v. United States*, 435 U.S. 561 (1978), a state bank, which was a member of the Federal Reserve System, entered a sale-leaseback transaction in which a bank nominally appeared as a long-term triple-net lessee of its new headquarters building, a corporation owned by one of the bank’s directors’ (the Frank Lyon Company) nominally appeared as the owner, and a third party lender, an insurance company, advanced the bulk of the construction costs. Through collateralization of the banks’ obligations as “tenant,” the insurance company

assured that the “rental” paid the amount it advanced as a loan. The economic substance of the transaction was that the bank was the owner and Frank Lyon was a lender, yet the Court allowed the Frank Lyon Company to claim the substantial tax benefits of an “owner” stating:

The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction. . . .

In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encourage by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

*Frank Lyon Co. v. United States*, 435 U.S. 561, 565-67 (1978); *see also Atlantic Coastline R. Co. v. Phillips*, 332 U.S. 168, 174 (1947) (quoting *Superior Oil Co. v. State of Mississippi*, 280 U.S. 390, 395, 396 (L. Hand & Holmes, JJ.)) (“As to the astuteness of taxpayers in ordering their affairs so as to minimize taxes, we have said that ‘the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it.’ This is so because there is [no] ‘public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions.’”).

The Requirement Of An Objective Profit Apart From Tax Does Not Apply Where Congress Used Tax Incentives To Change Investors’ Conduct

Relying on *Frank Lyon Company*, the Ninth Circuit held in *Sacks v. Commissioner*, 69 F.3d, 982 (9th Cir. 1995) that a taxpayer was entitled to claim depreciation deductions and investment tax credits on lease back transactions of solar energy devices:

If the Government treats tax advantaged transactions as shams unless they economic sense on a pre-tax basis, then it takes away from the Executive hand what it gives with the Legislative. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made. . . .

If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would otherwise not be made because of their low profitability . . . yet the Commissioner in this case, proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principal that statutes ought to be construed in light of their purpose. *Cabell v. Markham*, 148 F.2d 737 (2d Cir. 1945) (L. Hand, J.).

### Codification of Economic Substance

A codification of the economic substance doctrine is currently proposed. Affordable Health Care for America Act, H.R. 3962, 111th Cong. § 562 (2010). The Administration has advocated the statutory “clarification,” explaining:

The proposal would clarify that a transaction satisfies the economic substance doctrine only if (i) it changes in a meaningful way (apart from federal tax effects) the taxpayer’s economic position, and (ii) the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. The proposal would also clarify that a transaction will not be treated as having economic substance solely by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction. The proposal would allow the Treasury Department to publish regulations to carry out the purposes of the proposal.

### Taxpayer Successes

A recent author has provided a “template” for establishing economic substance. Nancy T. Bowen, “*Wells Fargo*” and *Economic Substance: Revisited the Blueprint for Taxpayer Success*,” DAILY TAX REPORT NO. 31, Feb. 18, 2010, at J-1. According to Ms. Bowen, successful economic substance cases have involved four common factors: the

transactions were done in the taxpayer's own industry and made sense in light of how the taxpayer had previously conducted its business; the taxpayer performed pre-transaction due diligence; the transactions had non-tax business purposes that were contemporaneously documented; and the taxpayer did not overly emphasize the tax benefits produced by the transaction. *Id.*

### Reportable Transactions

Another response to tax shelters was the enactment of enhanced disclosure requirements. Section 6011 of the Internal Revenue Code provide specific provisions for "reportable transactions." Reportable transactions include several categories of specific transactions determined to be potentially abusive. One category is "listed transactions" which are specific transactions designated by the IRS as abusive tax transactions. As of this date, the IRS has designated 34 transactions as "listed transactions," and four transactions as "transactions of interest." Similarly, another category is transactions designated as "transactions of interest." Reportable transactions include several general categories of transactions with tax abuse potential, including certain confidential transactions, certain transactions with contractual protection regarding tax consequences, certain transactions generating losses under Section 165 in excess of certain amounts, and others. Reg. § 1.6011-4.

A number of significant tax consequences result if a transaction is a "reportable transaction." First, taxpayers who have "participated" in a reportable transaction are required to disclose that fact on Form 8886 on their tax return and send a copy thereof to the Office of Tax Shelter Analysis ("OTSA"). Reg. § 1.6011-4. "Material advisors" who provide aid, assistance or advice with respect to the organizing, managing,

promoting, selling, implementing, insuring or carrying out any reportable transaction and who receive certain threshold amounts of income therefrom, are also required to report the transaction on Form 8918, (“Material Advisor Disclosure Statement”) and to maintain certain information regarding the participants and nature of such transactions, and to produce that upon request to the Internal Revenue Service. See I.R.C. §§ 6111, 6112.

Failure to disclose a reportable transaction, whether by the taxpayer participant or a material advisor, may be subject to large monetary penalties under Section 6707A. A material advisor’s failure to maintain required list information or to produce that information upon IRS request is subject to \$10,000 per day failure after the 20th day. I.R.C. § 6708. A taxpayer’s claim of a reportable transaction may result in a 20% penalty if the transaction is disallowed under Section 6662A, which can be increased to 30% if the transaction was not disclosed as required.

#### The Klein Conspiracy: The New Capstone

A third response to the technical tax shelter was the increased reliance on the so-called Klein conspiracy charge. *E.g., United States v. Klein*, 247 F.2d 908 (2d. Cir. 1957). In 1969, the Tax Division of the United States Department of Justice authorized a single count indictment against the Fruehauf Corporation. This indictment expressed a theory of criminal tax enforcement based upon a charge that the defendants conspired to impede and impair the lawful governmental functions of the Internal Revenue Service. The allegation was that Fruehauf had implemented a supplemental invoicing scheme which was designed to understate and conceal the true tax base, the

wholesale price to distributors. This indictment was the first time the Tax Division had used the conspiracy statute in this manner.

Under the conspiracy statute, Title 18, U.S.C. Section 371, it had always been a crime to defraud the United States of money, but here the charge was extended to the defrauding of the government of its right to fairly audit and enforce compliance with the tax law. The indictment resulted in the conviction of Fruehauf and its officers in 1975. See generally *United States of America v. Fruehauf Corp.*, 577 F.2d 1038 (6th Cir. 1978). This theory of prosecution—conspiracy to impede and impair lawful functions of the IRS—is the new capstone in the Government’s arsenal against complex criminal tax behavior.

A similar crime is defined in the Internal Revenue Code at Section 7212. That offense which is named “Attempt to Interfere with Administration of Internal Revenue Laws,” makes it a crime for any person to “corruptly . . . impede any officer or employee of the United States acting in an official capacity under this title, or in any other way corruptly . . . obstructs or impedes, or endeavors to obstruct or impede, the due administration of this title.”

#### Examples of Recent Charges in Criminal Tax Cases:

In August of 2005, the United States obtained an indictment against nine persons, lawyers and CPA’s, who were involved in the design, implementation and marketing of several tax shelters promulgated by KPMG. The lead Defendant in that case, Jeffrey M. Stein, had been KPMG’s number two executive. The Indictment charged that the Defendants participated in a scheme to defraud the IRS by devising, marketing, and implementing fraudulent tax shelters, by preparing and causing to be

prepared, and filing and causing to be filed with the IRS false and fraudulent U.S. Individual Tax Returns containing the fraudulent tax shelter losses, and by fraudulently concealing from IRS those shelters. The Superseding indictment alleged in pertinent part that:

In order to conceal the true nature of the tax shelter from the IRS, to attempt to evade the wealthy clients' U.S. individual income taxes, and to shield the clients from IRS penalty for underpayment of income taxes, KPMG and/or a law firm provided the clients with opinion letters containing false and fraudulent representations and statements claiming the tax shelter losses were "more likely than not" to survive IRS charge.

The opinion letters were alleged to be false in that the tax shelter transactions were falsely and misleadingly described as investment programs, when in truth and in fact the programs were designed, marketed, and implemented to generate phony tax losses.

The indictment also alleged that the manner and means of carrying out conspiracy included the preparation of false documents, soliciting false and fraudulent representation from clients, taking various steps to prevent the creation and retention of documents that might reveal to IRS the true facts regarding the fraudulent tax shelters, failing to register the shelters, using sham attorney-client privilege claims and concealing documents and providing false and misleading information in response to the IRS independent investigations.

#### Making Life Difficult For The IRS

An indictment was returned on October 22, 2009 in the Southern District of Ohio charges Defendant Daryl Haynor and John Flask (a tax attorney) with conspiracy to impede and impair the lawful collection of the revenue in violation of United States Code

Section 371. The subject of the indictment was the marketing and implementation of the SLOTS tax shelter. The indictment alleges that the Defendants “would and did design, market, and implement SLOTS tax shelter transactions, and make presentations to the IRS on behalf of SLOTS clients, *in ways that made it difficult for the IRS to detect* deceptive sales of LHI.” (emphasis added). It was also alleged that the Defendants:

would and did assist in drafting opinion letters that contained false and misleading information and omitted material facts; would and did provide false and misleading information to IRS in connection with the SLOTS clients; would and did make false and misleading statements during meetings with the IRS agents and attorney and would and did provide false, fraudulent and misleading information to the SLOTS clients.

#### False Representations

Significant problems arise in defending an audit or investigation of a tax shelter. For example, the government has taken the position that false representations are made when the taxpayer asserts a profit motive or business purpose for a tax shelter transaction. Depending upon the circumstances, such conduct may be viewed by the Internal Revenue Service as a continuation of the conspiracy to impede and impair. A false statement to the Internal Revenue Service is also a separate felony, a violation of 18 U.S.C. § 1001. This statute provides in pertinent part that:

[W]hoever, in any matter within the jurisdiction of the Executive, Legislative or Judicial Branch of the Government of the United States, knowingly and willfully –

- (1) falsifies, conceals or covers up by an trick, scheme or device, a material fact;
- (2) makes any materially false, fictitious or fraudulent statement or representation; or
- (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious or fraudulent statement or entry;

shall be fined under this Title, imprisoned not more than 5 years . . . .

Circular 230

Circular 230, 31 C.F.R., at 10, sets forth the standards of conduct applicable to practice before the Treasury. These standards include requirements that a practitioner exercise due diligence (Section 10.22); submit records and information to the Internal Revenue Service upon lawful request (Section 10.20) and not provide false or misleading information to the Internal Revenue Service (Section 10.51(a)(4)).

Circular 230, Section 10.22 provides in pertinent part that:

a. In general. – A practitioner must exercise due diligence –

(1) in preparing or assisting in the preparation of, approving and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(2) in determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) in determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

Circular 230, 31 C.F.R., at 10, § 10.22.

Section 10.20 describes the information to be furnished to the Internal Revenue Service. In pertinent part, it provides as follows:

(1) A practitioner must on proper and lawful request . . . promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

(2) Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of

any person who the practitioner believes may have possession or control of the requested records or information.

Circular 230, 31 C.F.R., at 10, § 10.20.

Section 10.51 describes *incompetence and disreputable conduct*. Among the prohibited conduct is:

(4) Giving false or misleading information, or participating in anyway in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters . . . .

Circular 230, 31 C.F.R., at 10, § 10.51(a)(4).

### Conclusion

Those who have designed and implemented aggressive “technical” tax shelters have been charged and convicted of impeding and impairing lawful functions of the Internal Revenue Service. The mistake made by these tax shelter promoters arises from a fundamental misunderstanding of the conduct required by those who promote or implement aggressive tax plans. It was erroneously assumed that in the “gray” areas of tax law, one may take aggressive technical positions in complex transactions having little or no economic substance, and then aggressively defend these positions if audited. These promoters apparently believed that in such situations, the worst case scenario was that the Internal Revenue Service would assess only tax and interest or perhaps a civil penalty. They also believed that reliance on a technical tax opinion would permit the taxpayer to assert the Section 6664 reasonable cause exception to any civil penalty. The mistake was in assuming that aggressive reporting of “gray areas,” permits one to engage in deceptive or misleading tactics. Some very bright, well known and respected

accountants and lawyers have now been convicted of criminal offenses based upon this mistaken assumption.

Thus, tax practitioners must be able to distinguish tax evasion from lawful but aggressive tax reporting. These are the three broad rules which distinguish lawful from unlawful conduct:

1. To engage in lawful tax reporting, a taxpayer must have a “reasonable basis” for a tax return position. As indicated previously, a reasonable basis is significantly higher than a mere colorable claim or “arguable” position. This also requires that a practitioner exercise due diligence to determine that the relevant transactions are grounded in economic realities: “A melody is more than the notes.” Caution is required when an incomprehensible transaction, extraneous to the taxpayer’s business, produces significant tax benefits. See *Brown, supra*. A practitioner satisfies this rule by complying with Sections 6662 and 6694 of the Internal Revenue Code and with Circular 230, Section 10.22.
2. One must carefully comply with all disclosure and notice provisions of the Internal Revenue Code. Intentional failure to comply can be an indication of an intent to conceal. A practitioner complies with this rule by exercising due diligence to meet the requirements of Sections 6011, 6662 and 6694 of the Internal Revenue Code and with Circular 230, Section 10.22.
3. One must carefully avoid any conduct indicating an intent to impede the Internal Revenue Service in the “ascertainment, computation, assessment and collection of federal income taxes.” This requires absolute avoidance

of any conduct “the likely effect of which is to mislead or conceal.” See Circular 230, Sections 10.20, 10.22 and 10.51(a)(4).

As one prosecutor has said—criminal conduct is all about “the big lie.”